Driving growth with new products: common pricing traps to avoid

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It is essential for companies to develop better pricing strategies for a larger and more complex worldwide marketplace. Conventional wisdom says the best time to launch new products is in the early stages of an economic upturn as demand picks up and customers become less price-sensitive. While this may be true for some products, many companies miss a significant opportunity to maximize revenue and profits due to dysfunctional pricing strategies.

During the recession of 2001-2004, entire markets were consumed by ad hoc discounting by companies trying to defend their piece of a shrinking pie. In the process, companies sent a clear signal to customers that price was negotiable and value would be given away when pushed hard enough. Many companies also began bundling additional products and services into their core offering to “sweeten the deal” and make the sale. By giving away services, these firms drove up their costs and taught customers their services were not highly valuable. These short-sighted pricing approaches may have helped sustain sales, but they also taught customers to focus on price and ignore value.

Throughout the world, countries are exploring ways to take advantage of the world economies by taking on new manufacturing capabilities to deliver products globally. Asian countries have clearly expanded beyond cheap apparel manufacturing by supplying consumer electronics, technology support services, automobiles and more. Ireland has become a major provider of outsourced services. With products and services being sold around the world, companies need to find effective pricing mechanisms for both domestic sales within their country borders and the pricing methods that support their export market.

Closer to home, pricing reductions have been common with companies that have high fixed costs and low variable costs. Two examples come from the software and automobile industries. Software companies provided deep discounts and extended free trial periods to encourage buyers. Automobile companies have used the discount plan-of-the-month, including low financing interest rates, to generate sales and lower their inventory of new cars.

During 2004, research by the Product Development Management Association, along with a Strategic Pricing Group study, indicate there is less than a 50 percent chance new products will hit their volume and profit goals. While there are numerous reasons for these failures, ineffective pricing strategies are one of the most overlooked aspects of new product development and marketing campaigns. Setting the selling price is most often the last step in the entire product development cycle, but it may not allow adequate time between end of product development and start of product launch to appropriately gauge the product’s value to the buyer. That’s because when setting a price, companies need to combine the bookkeeping calculation that judges cost vs. revenue to arrive at an acceptable gross margin with potential value price that a buyer would be willing to pay.
There are three common pricing traps that can derail new consumer or business-to-business product marketing success. Avoiding these traps is critical for firms to drive new earnings and growth. They are:

1. pricing benefits instead of value;
2. managing customer risk with price; and
3. failure to manage the post-launch price trajectory.

**Trap one: pricing benefits instead of value**

In 2004, Strategic Pricing Group completed a study of **Fortune** 1000-US-based companies. The demographic focus was on product managers and their understanding of product value. While the study respondents were all large companies, we believe the results are relevant to companies of all sizes. Of the responding product managers, 70 percent indicated their biggest challenge in new product pricing was how to understand (and quantify) the value their products and services delivered to customers. The tendency is for companies to either grossly overestimate or underestimate the value their product delivers to customers.

One recent example comes from a medical device manufacturer that developed a new tool that could speed up certain clinical tests by as much as tenfold. The new product was highly praised by customers and the press. Despite the kudos, sales fell far short of expectations a few months after launch. Research determined that different segments of the market realized significantly different value from this product. On one side, pharmacies saved enormous amounts of money by reducing the labor required to run thousands of testing procedures per month. On the other hand, universities found the productivity improvements actually destroyed value because it reduced the amount of time that students expended to learn the testing procedures.

To handle this issue, the company did not change the product. Rather, it found that each segment had a different perceived value of the product and its use. Consequently, pricing was adjusted for each segment, higher for the commercial side (pharmacies, for example) and lower pricing for the university segment.

As this example illustrates, understanding the economic value a product brings to different customer segments is an essential ingredient to launching new products. Moreover, economic value must be understood in relation to the value delivered by competitors because customers are comparing competitive offerings when making a purchase. With this data collected, any company can begin to develop a credible approach to setting prices.

When companies rely on traditional marketing research techniques such as focus groups, surveys and conjoint studies, they are unable to determine how the new product will drive revenue or reduce costs for customers. Focus groups are helpful to understand the types of benefits a specific product might deliver to customers. Surveys can provide validation for how those benefits vary across customers segments. Conjoint studies can provide statistically significant results for how much customers are willing to pay for a new product. Yet, the most effective way to assess the value a company’s products bring to its customers is through in-depth interviews, which enable the company to understand its customer’s...
business model. Armed with intimate knowledge of how a company’s product affects the customer’s business, the company can construct an economic value model that becomes the foundation for effective pricing and sales strategy. This step, along with appropriate sales training, has resulted in tens of millions of dollars in additional revenue for companies.

There are many examples that demonstrate value pricing. A large software database company was planning to sell a new product for $99. After assessing the potential value of its new product, the price was more correctly priced at $349. Another example is a health care company that had developed an internal tool that saved the company millions of dollars. The company decided to market this product set to other health care firms. The initial price point was $500, which did not provide enough of a gross margin to make introducing the product worthwhile. After research into the value of this product, the company estimated the value at 30 to 40 times the early estimates. The company then changed the pricing to $2,500 and still generated a significant number of sales, making a sound profit for the company.

**Trap two: managing customer risk with price**

By definition, new products involve some risk to customers because they represent un-tested solutions to their perceived needs. For incremental innovations involving minimal changes in technology or customer use, the risk to customers is lower. However, it is a far different story for more innovative products because they present customers with a dilemma. They offer the potential to dramatically reduce costs or drive revenue relative to existing solutions (i.e. they create significant economic value). At the same time, it is unproven whether the product can actually deliver on its value proposition.

Although customers may recognize that a new product or service has the potential to create significant value, they must weigh that potential against the possibility that the underlying technology will fail or that the seller has not worked out all of its “bugs.” The most common result is sluggish post-launch sales because existing customers and prospective customers are reluctant to be the first to test a new offering. When faced with this challenge, many companies make the critical mistake of attempting to help customers overcome their perceived risk by turning to price discounting. The logic for this price reduction is that lower introductory prices will bring customers into the market, creating sales momentum for the new product. Unfortunately, price discounting rarely works for innovative products because it fails to address the real problem – customer risk – while creating low price expectations that reduce margins on future sales. When launching innovative products or services, a far better approach is to maintain price levels and develop a separate strategy to manage customer risk.

One firm used this approach with excellent results when it introduced a handheld computer to help doctors record patient notes into an electronic record. The device created significant time savings for individual doctors and their staff. On the other hand, hospitals perceived considerable risk that the device would be lost or stolen and were reluctant to purchase large quantities. Initially, the sales force responded to these objections with price discounts. But an analysis of the firm’s sales records revealed that less than 1 percent of orders were to replace lost or stolen devices, indicating that the actual risk was much lower than customer perceptions. Instead of steeper discounts, the firm launched a no-theft guarantee where replacements would be provided free for any stolen device. The guarantee was a big hit with customers and turned a major negative into a significant driver of their value proposition. Moreover, the cost of the program was miniscule compared to the lost contribution the company would have experienced had it tried to fix the problem through price discounting.

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Companies can adopt a variety of sound risk management strategies to help support more stable prices and encourage early product adoption. Some of these include performance guarantees, beta testing and free trials to help drive acceptance of new products. In addition, a powerful technique gaining momentum in the software industry is usage-based pricing, which ties the price customers pay directly to the amount of the product used. The more customers use a product, the more they pay. In technology markets, usage-based pricing metrics are rapidly becoming the norm as customers balk at paying for a fixed number of licenses, many of which do not get used and become shelf wear. A usage-based metric that tracks the number of users, degree of functionality used, and/or the time of use, removes the customer’s risk of over-buying and helps control costs. The challenge of usage-based metrics is that they force sellers to really understand the economic value they bring to customers to set the right price level. While this can be a daunting task, when the seller does its homework and assesses the economic value to the customer, setting the right price metric becomes fairly routine.

Trap three: failing to manage the post-launch price trajectory

In today’s marketplace, the value of a new product begins to erode the moment sales begin. Global competition is fierce, with known rivals and distant unknown rivals copying features and cutting prices to gain market share. For example, the apparel industry exists in the midst of significant issues surrounding design copy and price undercutting. Instead of proactively managing these predictable market dynamics, too many firms adopt reactive, short-term pricing strategies that drive down industry price levels and reduce profits for everyone. Competition creates an opportunity to use price as a weapon. The key is to not give away price in the heat of the battle. A global industrial manufacturer recently introduced a new set of diagnostic tools for energy producers that offered significant performance improvements over its major competitor. Happily, sales exceeded the target, and the marketing team felt that the launch was successful. But after a few months, the sales force reported customers were beginning to push back on price, demanding significant discounts to close the deal. When the price pressure continued, the team performed an Economic Value Estimation (Strategic Pricing Group’s proprietary approach to quantify and price products) to better understand what was happening in the market. The results were telling.

At launch, the product offered significant economic value compared to the major competitor. However, in an effort to grow share, the team had conservatively priced the product just above the competing product, creating a strong inducement for customers to switch. The competition responded with a price cut of its own, which only encouraged customers to seek similar price cuts from the company. By failing to carefully think through its post-launch pricing strategy, the company lost hundreds of thousands of dollars and accelerated the commoditization of its own product. The results were less than satisfactory, as the product did not attain revenue expectations. It is important to recognize and learn about steps companies can take to delay price erosion. For example:

- **Upgrade value – not features.** Periodically, companies believe that the only way to stay ahead of competition is to enhance products through added features. The problem with this approach is that it often leads to overbuilt products that do not necessarily solve customers’ business problems. Instead of simply adding features without a strategy, companies would be better off to prioritize proposed new features based on the
economic impact they have on customers’ businesses. Firms adopting this feature-add approach typically find some of the features they planned to include get eliminated while other features that were not even considered get a high priority. IBM introduced its ThinkPad laptop into a crowded and competitive laptop market. To differentiate its computer, IBM made sure that security was a significant component of their features and marketing. Thus, the consumer was able to assess the added value to be received from a more secure laptop computer.

- **Plan service rollout over several stages.** One of the most powerful ways to augment the value proposition of a product and resist price pressure is through carefully planned service enhancements. By augmenting products with service solutions, it enables companies to present a “fresh” solution to customers at a time when they are ready to buy. But be careful, the goal is not to provide the most services, only the most valuable ones. Well-planned services can be rolled out to coincide with the maturity of the product offering and become an important part of creating loyal and lasting customer relationships. Adobe software has done this by periodically integrating whole new features, such as access to stock photo database and photo finishing services. In this way, Adobe has been able to sustain a retail price higher than its competition.

- **Focus on share of wallet.** One of the chief reasons for the decline of new product prices is the mismanagement of competitive pricing interactions. Companies launching products and targeting new accounts often run the risk of starting price wars with entrenched competition. An alternative approach (especially in mature markets) is to shift the focus from acquiring new accounts to one of capturing a bigger share of current accounts. Focusing on share of wallet instead of market share enables companies to capture new sales in a less threatening way and will less likely invoke a significant competitive response. Seeking more sales with existing customers is being done throughout the telecom and cable industries. Local calling, long distance calls, Internet access, cable television signals, cellular service are being combined by Comcast, and the baby bells are working hard to gain long term customer commitments for multiple services.

**Pulling it all together**

New products stimulate future revenue and profit growth for all companies. Therefore, it is critical to avoid the traps that can undercut price integrity. At best, getting snagged by these traps reduces profits and hurts sales. At worst, they put companies at a significant disadvantage when negotiating with customers and help accelerate price deflation across specific market segments. The good news is that these pitfalls can be avoided when companies develop a clear understanding of the economic value they bring to customers. Based on the perceived value, companies need to learn how to leverage their product introductions through a proactive pricing strategy.

It is simply wrong to squander the success of any new product launch with poor pricing decisions that can limit growth and reduce bottom line profits. When going through the process of developing pricing models and the entire product pricing strategy, it is essential to manage the value proposition that exists between product seller and product buyer. Twentieth century methods of pricing products need enrichment to be successful in the twenty-first century. The Internet provides to both business and individual consumers the capability to track prices around the globe any day of the year. Consequently, it can be anticipated that when ready to buy, the consumer already knows the price and needs to be convinced based on their perceived value. Implementing a value-based new product-pricing model is the essential part of a better business strategy that can be started now.

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